85-233 (1)

No. 85-

Supreme Court, U.S.
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In the Supreme Court of the United States

OCTOBER TERM, 1985

FUTURA DEVELOPMENT CORPORATION,
PETITIONER,

v.

CENTEX CORPORATION; CENTEX HOMES CORPORATION; S CORPORATION; 111 E. CHESTNUT CORPORATION, TRUE NAME OF WHICH IS UNKNOWN TO PLAINTIFF; FRANK M. CROSSEN; PAUL R. SEEGERS: JAMES E. LEWIS; JACK R. McDONALD; ROBERT I. HAGGART; ROBERT PRIGMORE; JOSEPH S. POWELL; "JOHN POLONY" THE TRUE FIRST NAME OF WHICH AND THE CORRECT SPELLING OF THE SURNAME IS PRESENTLY UNKNOWN TO PLAINTIFF; AND JOSHUA MUSS,
RESPONDENTS.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

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I

QUESTIONS PRESENTED

In a suit under the Rule 10(b)(5), 17 C.F.R. §240 10(b)5 (1984); §17(a) of the Securities Act of 1933, respondents sought dismissal on the ground that the Purchase Money Mortgage Note ("PM Mortgage Note") which served as basis for Petitioner's Securities Fraud Claim was not a security within the purview of the Federal Securities Laws. The District Court dismissed the petitioner's securities claim on the grounds that the PM Mortgage Note was not a security within the context of the Federal Securities Laws; and that said claim was barred by the applicable statutes of limitation. In addition, Petitioner was not permitted discovery relative to material fact questions pertaining to whether the PM Mortgage Note was a security within the context of the Federal Securities Laws and whether the Securities Law claim was time barred. The Court of Appeals affirmed. The Questions presented are:

1. Whether the Circuit Court erred in affirming the District Court's holding that the PM Mortgage Note is not a security as contemplated by the Securities Laws of the United States.

2. Whether the Circuit Court erred in implicitly affirming the District Court's holding that the PM Mortgage Note is not a security contemplated by the Securities Laws of the United States, without first permitting Petitioner to engage in discovery on the issue, and without the District Court having a full hearing on the issue.

3. Whether the Circuit Court erred in affirming the District Court's holding that the two year statute of limitation barred Petitioner's Federal Securities Law claims.

4. Whether Congress in the Securities Acts intended to cover only "passive investors" and not privately negotiated transactions involving the transfer of control to Entrepreneurs.

II

PARTIES

In compliance with Superior Court Rule 28.1, the following list is provided of subsidiaries and affiliates of Futura Development Corporation: M. D. Construction Co. Inc. (Puerto Rico Corporation), Luna Engineering Corp. (Puerto Rico Corporation), Arias Realty Corp. (Puerto Rico Corporation), April Industries Inc. (Delaware Corporation), Granco Development Corp. (New York Corporation), 1411 Leasing Company, Inc. (New York Corporation), 1411 LT. Limited Realty Inc. (Delaware Corporation), Construction Team Corp. (Puerto Rico Corporation), April of Connecticut Inc. (Connecticut Corporation), TAH Corporation (Puerto Rico Corporation), PT Corp. (Puerto Rico Corporation).

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RESPONDENTS.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

Petitioner prays that a Writ of Certiorari issue to review the Judgment of the United States Court of Appeals for the First Circuit entered on April 30, 1985.

Opinions Below

The opinion of the District Court for the District of Puerto Rico dismissing Petitioner's complaint is printed in Appendix A hereto (App. A-1) and was entered on March 30, 1984. The Opinion of the Court of Appeals for the First Circuit affirming the District Court's dismissal is printed in Appendix B hereto (App. B-1) and was entered on April 30, 1985.

Jurisdiction

The Judgment of the Court of Appeals for the first Circuit was entered on April 30, 1985 and copy thereof is appended to this Petition in the Appendix (App. C-1). The Jurisdiction of this Court is invoked pursuant to 28 U.S.C. §1254(1).

Statutes and Federal Rules Involved

The Statutory Provisions involved are the Securities Exchange Act of 1934, Rule 10(b)(5); Securities Act of 1933 §17(a), 17 C.F.R. §240 10b-5 (1984); 15 U.S.C. §77b(1); 78c(a)(10) (1982).

Statement

This suit under the Federal Securities Laws arises from the fraudulent acts of respondents involving a Mortgage Note. The basic facts which are not in dispute are as follows:

During the first part of 1975, Petitioner, Futura Development Corporation ("Futura") entered into negotiations with co-respondent 111 E. Chestnut Corporation ("Chestnut") a wholly-owned subsidiary of Centex Corporation ("Centex") to sell a tract of land comprising 218 cuerdas[1] (approximately 210 acres in round numbers) (the "Property") for development of residential units. Chestnut only showed interest in purchasing a portion of the Property comprising 108.0671 cuerdas (hereinafter referred to as "Section 1").

[1] An acre is approximately 1.1 cuerdas.

Futura made it clear during the course of the negotiations that it would only sell the Property as a whole and would not agree to Chestnut's original proposal to purchase only 100 acres, the Property was worth more as a whole than its parts would be if sub-divided. Centex, through Chestnut and other corporate and individual respondents devised a scheme through which they intended to accomplish their objective of only purchasing Section 1 (the 108.0671 cuerda tract).

In April of 1975, Futura and Chestnut executed a Deed of Sale for the whole Property for the purchase price of $4,584,713.70 ("Purchase Price"). The sale was structured so that the Purchase Price would be paid as follows: $1.3 million was paid in cash at the time of the sale; Chestnut assumed the payment of a first mortgage on the Property for $1.8 million; and Chestnut gave Futura the PM Mortgage Note for the remaining $1.4 million which was secured by a second mortgage on the Property.

The PM Mortgage Note provided that Chestnut would pay the principal plus 9% annual interest in two installments. The first installment of $742,356.85 was payable four years later, on February 1, 1979, and the balance of $742,356.85 was payable the following year on January 31, 1980. The PM Mortgage Note provided that if Chestnut failed to pay the principal and interest of the first installment due on February 1, 1979 and did not cure the said default within thirty days, Futura could accelerate the unpaid balance.

The PM Mortgage executed with a view towards Chestnut's development and eventual sale of the residential units to be constructed on the Property, gave Chestnut the right to periodically procure releases of portions of the Property from the effects of the PM Mortgage. Futura agreed to release Section 1 of the Property (108.0671 cuerdas) (which Chestnut originally sought to buy separately), without any further payment to Chestnut regardless of whether Chestnut was in default on the PM Mortgage Note. Chestnut could seek further

releases of the other portions of the Property, consisting of five parcels ranging in size from seventeen to twenty-six cuerdas in a specified order upon payment of approximately $16,825 per cuerda so long as Chestnut was not in default.

On February 1, 1979, Chestnut failed to pay the first installment due on the PM Mortgage Note. According to an affidavit of the Executive Vice-President of Futura, Futura, upon inquiry, was told that Centex and another of its subsidiaries would assume and guarantee payment of the PM Mortgage Note. Futura was also then informed by two Centex co-defendant officials and employees that a check for the first installment of the PM Mortgage Note was in process of being forwarded to Futura. On February 9, 1979, Futura executed a release for Section 1 of the Property (the 108.0671 cuerdas) and its lien position on the remainder of the property was elevated to a first position pursuant to the mortgage agreement, by the payment by Chestnut/Centex on February 21, 1979 of the $1.8 million mortgage note and cancelled the first mortgage of which it had assumed payment at the time it bought the Property from Futura. The result of the 1979 reshuffling was that Section 1 was encumbered by a first lien of $10 million and a second lien of $700,000 (bearer mortgages). The remainder of the Property was subject to a first mortgage lien of $700,000 by Futura subordinating its first mortgage, a second mortgage lien of $1.4 million (Futura's mortgage) and a third mortgage lien of $10 million.

February 1979 passed and the check representing payment of the first installment of the PM Mortgage Note that was promised delivery to Futura never arrived. Futura again demanded payment by letter in March 1979, but received no satisfaction. On January 31, 1980 Chestnut defaulted on the second installment of the PM Mortgage Note due Futura.

A year and three months after the 1979 default, Futura filed suit against Chestnut and two unnamed agents of Chestnut in the Puerto Rico Superior Court to collect the principal and interest due.

During the course of this lawsuit in the Superior Court of Puerto Rico, Futura and Chestnut/Centex entered into negotiations, during the course of which (September-October 1981) the president of Centex informed the president of Futura (according to an Affidavit of the President of Futura) that neither Centex nor Chestnut had ever intended from the inception of the purchase of the Property to pay the balance of the Purchase Price as represented by the PM Mortgage Note.

Futura maintains that the fraudulent representations made by Centex and Chestnut of purchasing the entire Property and promise of Centex to pay the PM Mortgage Note, none of which was intended to be performed, constitute a fraud in connection with the purchase and sale of a security, a fraud (i) that was initiated in 1975 when Futura rejected Chestnut's offer to purchase only Section 1, and Centex realized that the only way its subsidiary, Chestnut, could acquire Section 1 (which it wanted and was willing to pay for) was to acquire the rest of the Property at the same time (which it did *not* want and was *not* willing to pay for), (ii) that was designed by Centex to permit the payment of a down payment (of the Purchase Price) on the whole Property equal to the amount Centex had originally offered Futura for only Section 1, and then, the insertion of a non-personal liability clause in the PM Mortgage Note, and caused Centex to fraudulently induce Futura into liberating Section 1, and permit the foreclosure of the rest of the Property. Thus, as planned from the beginning, Centex artfully managed to end up with Section 1 for the price it had been originally willing to pay to Futura when Centex made, and Futura rejected, the initial offer in 1975. And because the whole scheme was devised, planned and orchestrated from the inception of the transaction in 1975 and executed through the use of the PM Mortgage Note, such scheme constitutes Securities Fraud under Rule 10(b)5. Moreover, because the scheme was not discovered until September-October 1981, the action for Securities Fraud filed by Futura in the District Court for the District of Puerto Rico on March 24, 1982, was timely filed.

Respondents moved for dismissal of Petitioner's Securities claim on the ground that the PM Mortgage Note was not a security within the context of the Federal Securities Laws. The District Court granted respondent's request for dismissal on the aforementioned ground, as well as, amongst other grounds, that the action was barred by the applicable Statute of Limitation. The Court of Appeals affirmed, concluding that even though the PM Mortgage Note executed at the time of the sale of the Property clearly falls within the literal language of the Federal Securities Laws, the "economic realities" of the transaction show it was not a Security.

Reasons for Granting the Writ

The decision below should be reviewed because it erroneously interprets the Federal Securities Laws as being intended to cover only "passive investor" and not privately negotiated transactions involving the transfer of control to "entrepreneurs".

> "The note's stated value was in no way dependent upon the entrepreneurial efforts of Chestnut, Centex or any of their associated companies." (App. B-14)

To the contrary, the payment of the PM Mortgage Note was dependent upon the development of the project by Chestnut/Centex being successful; this was a key factor in the original transaction in 1975. When Centex and the other co-respondents represented to Futura that they intended to develop the whole property, but in fact they had no such intention, this caused Futura to rely on such representations and enter into the sale transaction, the respondents were committing fraud (a) in connection with the Purchase or Sale of a Security, and (b) based on a transaction in which respondents' entrepreneurial efforts were the focal point of reliance.

Either the decision below is in conflict with the decisions of this Court in *Landreth Timber Co.* v. *Landreth*, __ U.S. __,

105 S.Ct. 2297 (May 28, 1985) and *Gould* v. *Ruefenacht, et al.*, __ U.S. __, 105 S.Ct. 2308 (May 28, 1985), or if it is not so in conflict, then the "issues of far-reaching importance" left undecided in those cases must be faced. In either event, this Court should grant review.

This Court's attention is drawn to a relevant portion of its decree in *Landreth Timber* (supra):

> "Although we do not decide whether coverage of notes or other instruments may be provable by their name and characteristics, we do point but several reasons why we think stock may be distinguishable from most if not all of the other categories listed in the Acts' definition of instruments that bear both the name and all of the usual characteristics of stock seem to us to be the clearest case for coverage by the plain language of the definition." (*Landreth Timber* at 2306)

The holding in the Court below is further in conflict with the decision of this Court in *United Housing Foundation Inc.* v. *Forman*, 421 U.S. 837, 95 S.Ct. 2051, 44 L.Ed.2d 621 (1975), inasmuch as it practically eliminates the Court's ability to hold that an instrument is covered by the Securities Acts when its characteristics bear out the label.

The questions presented by this case are of great and recurring significance in the effective implementation and enforcement of the Federal Securities Laws. The important nature of these issues has already been recognized by this Court as recently as *Landreth Timber Co.* v. *Landreth*, supra, and *Gould* v. *Ruefenacht, et al.*, supra. The serious question of public policy involved here and the effect of the decision below, if reversed, upon all future transactions involving securities makes this case an appropriate one for the exercise of this Court's discretionary jurisdiction.

Conclusion

For the reasons set forth above, it is respectfully submitted that this Petition for a Writ of Certiorari should be granted.

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APPENDIX A

IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF PUERTO RICO

CIVIL NO: 82-0729

FUTURA DEVELOPMENT CORP. OF PUERTO RICO, INC.,
PLAINTIFF

v.

CENTEX CORPORATION, ET AL.,
DEFENDANTS

RE: COLLECTION OF MONIES
CONSPIRACY

MEMORANDUM OPINION

Futura Development Corp. of Puerto Rico, (hereinafter "Futura"), plaintiff, brought this suit allegedly under Section 17(a) of the Securities Act of 1933 and Section 10b-5 of the Securities Exchange Act of 1934 (15 U.S.C. 77q(a), 78j(b)). Futura also seeks judgment on a promissory note issued by co-defendant 111 E. Chestnut Corp. (hereinafter "Chestnut"), in the amount of $1,484,713.10 (hereinafter "the $1.4 million note", "the Note" or "the PM Note") plus interest and attorney's fees. The other causes of action, hereinafter to be described more fully, relate to damages, breach of contract and the piercing of the corporate veil of Chestnut. Diversity of citizenship jurisdiction is also asserted by Futura.

The codefendants have moved to dismiss the complaint on several grounds; among others, that the securities claims are time-barred or, that the promissory note involved is not a security. The counts relating to collection of monies, damages, breach of contract and piercing of the corporate veil are being attacked by codefendants on several other grounds; among

others, that Futura is precluded from raising these claims in this Court since they are *res judicata* by virtue of a partial summary judgment entered against Futura by the Superior Court of Puerto Rico, Carolina Section, Civil No. 80-2664. For the reasons indicated in this Opinion, the Motion to dismiss is hereby granted.[1]

I.

Introduction

Futura's complaint contains ten causes of action. The first cause of action alleges that Centex Corporation, one of the codefendants, is the alter ego of the other corporate codefendants, Centex Homes Corporation, S Corporation, 111 E. Chestnut Corporation (hereinafter "Chestnut") and X Corporation. In essence, Futura claims that Centex Corporation dominated and controlled, through stock ownership, the decisions and corporate affairs of those codefendants. In this respect, Futura requests the piercing of the corporate veil of these codefendants and that they be held to be alter ego of Centex Corporation.

The second cause of action alleges a conspiracy by the codefendant corporations and the individuals named in the complaint as officers of these corporate entities to defraud Futura by causing Chestnut to issue the $1.4 million note which Futura says Chestnut never intended to pay. The $1.4 million note forms part of a commercial transaction which will be fully described hereinafter in our opinion. In this second cause of action, Futura seeks to recover damages in the amount of $1.4 million, being the principal of the $1.4 million note, plus the amount of interest and attorney's fees stipulated in said note.

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[1] Since the parties have presented matters outside the pleadings, the defendants' motion shall be treated as one for summary judgment. See, Rule 12(b), F.R.C.P.

The third and fourth causes of action restate the same conspiracy, but with its purpose being to induce Futura to consent to the subordination of its mortgage which secured the $1.4 million note, to the mortgage securing a debt in the amounts of $700,000. The purpose of the conspiracy also allegedly included the inducement to obtain fron Futura its consent to release and liberate a certain portion of the land which originally secured its $1.4 million mortgage. In summary, the alleged conspiracy charges that Chestnut and the other alter egos of Centex Corporation, through the officers named in the complaint, falsely promised Futura that the $1.4 million note would be paid and it was on the basis of that false promise that Futura was induced to execute the release, liberation and subordination stated above.

The fifth cause of action is a repetition of the third and fourth, except that Futura alleges here that Centex Corporation and S Corporation had agreed to pay the $1.4 million note and that it was on the basis of this false promise that Futura had agreed to release, liberate and subordinate its $1.4 million note. In causes of action three, four and five, Futura seeks to set aside and cancel the release, liberation and subordination, and to collect the principal amount of the $1.4 million note, plus interest and attorney's fees.

The sixth cause of action combines charges of conspiracy and alter egos whereby Futura was defrauded by Chestnut, S Corporation, X Corporation and Centex Corporation through a scheme whereby certain assets and stock dividends were transferred from Chestnut into X Corporation in order to render Chestnut judgment proof. Futura again seeks to pierce the corporate veil of these corporations and a declaration that they are all one and the same.

The seventh cause of action—the only federal claim—charges that the conspiratorial schemes alleged in the preceding causes of action constitute violations to the Securities Act of 1933 and Securities Exchange Act of 1934,

respectively. Futura here seeks damages equal to the principal of the $1.4 million note, as well as interest and attorney's fees.

The eighth cause of action requests damages in the amount of $5,000,000 plus 20% interest allegedly suffered as a result of the non-payment of the $1.4 million note.

The ninth cause of action is a breach of contract allegation premised on the obligation of Chestnut to pay the $1.4 million note. Again, its non-payment has allegedly caused damages in an amount of money equal to the principal of the $1.4 million note, plus interest and attorney's fees.

The tenth cause of action asserts that the liberation was obtained by Chestnut through fraud and deceit because Chestnut defaulted on the $1.4 million note and, thus, Futura was under no obligation to execute the deed of liberation. The same damages pleaded in the preceding cause of action are also requested here.

II.

The Facts

A brief description of the commercial transaction which is at the core of the present controversy is in order. On April 10, 1975, Futura sold to Chestnut a parcel of land located in the municipality of Rio Grande and Carolina, Puerto Rico, for the purchase price of $4,584,713.70. Chestnut made a cash payment to Futura of $1,300,000.00, and assumed the first mortgage of $1,800,000.00. The balance of $1,484,713.70 was to be paid in two installments of $742,356.85, each being due on February 1, 1979 and January 31, 1980, respectively. Also on April 10, 1975 a Deed of Mortgage was executed between Chestnut and Futura to secure the Note. Additionally, Chestnut issued two Bearer Mortgage Notes on the property. A $700,000.00 Note was executed for the purpose of financing plan developments and improvements on the land. A ten million dollar Note was executed to obtain financing for development and construction of certain residential units.

The following provision of the mortgage given by Chestnut to Futura is relevant to the issues in this litigation:

> "Seventh: The second party has accepted the Note secured by this Mortgage and this Mortgage with the understanding that first party shall never be personally liable for the payment of any sums whatsoever by reason of the making of said Note on this Mortgage, or by reason of default in the performance of the terms of said Note and this Mortgage, second party having agreed with first party that the enforcement of the rights of second party under said Note and under this Mortgage are limited to the security of the real property encumbered by this Mortgage at the time second party seeks to enforce his mortgage, and first party shall never be personally liable for the payment of any sums whatsoever unto second party, its successors and assigns, by reason of first party having executed said Note and this Mortgage".

The $1.4 million dollar Note contains similar language relative to the non-personal liability of Chestnut. The Deed additionally provides in paragraph 9 that Chestnut had the right to segregate the portion of 108 cuerdas (hereinafter Section 1 of the property) from the parcel of land involved in the transaction, and that Futura, upon request by Chestnut, would release and liberate Section 1 from its $1.4 million dollar mortgage. Additionally, Futura expressly agreed to subordinate its $1.4 million dollar mortgage on the remnant portion of the property (hereinafter Section 2 of the property) to the $700,000.00 mortgage issued by Chestnut to finance the plan developments and land improvements mentioned above. Thus, Futura became obligated to execute the necessary documents relating to the release, liberation and subordination without any further obligation on the part of Chestnut. On February 9, 1979, the deeds of segregation and release and liberation were executed by Chestnut and Futura. The deed of subordination was executed on February 13, 1979.

Chestnut defaulted on the first installment payment on the $1.4 million dollar Note. Futura then filed a lawsuit on May 9, 1980 against Chestnut, John Doe and Richard Roe, seeking judgment on the $1.4 million dollar Note and to set aside the $700,000.00 lien which was prior in rank to its $1.4 million dollar mortgage. Futura also sought to foreclose on its mortgage and that it receive title to the property free from the $700,000.00 lien. On April 23, 1982, Chestnut filed a Motion for Partial Summary Judgment. In its Motion, Chestnut alleged the facts as noted above, and moved the Court to enter partial summary judgment to the effect that the remedy available to Futura was limited to foreclosure on the portion of the land which was securing its $1.4 million dollar Mortgage Note, subject to the $700,000.00 lien heretofore-mentioned. It also requested a ruling that pursuant to the terms of $1.4 million note and the Deed of Mortgage, Chestnut was not personally liable to Futura on the $1.4 million Note. On July 10, 1982, Futura filed its Opposition to Chestnut's Motion for Summary Judgment and, in turn, moved the Court for summary judgment on the basis of the facts which appeared to be uncontroverted. Futura expressly relied on the same facts which we have stated earlier.

Meanwhile, on March 26, 1982, Futura filed the present lawsuit against Chestnut and thirteen co-defendants. It appears from the records of this case however, that the Summons by Edict were not issued until May 12, 1982. On July 28, 1982, the Complaint was amended, exactly 18 days after Futura had filed its Motion for Summary Judgment in the local court. This is important because in the Superior Court, Futura's posture was that the segregation, liberation and subordination had been valid transactions, while in the amended complaint it seeks to invalidate these same transactions on different grounds.

On December 3, 1982, the Superior Court of Puerto Rico, Carolina Section, entered partial summary judgment as re-

quested by Chestnut. The trial court held that the non-recourse provision contained in the Deed of Mortgage between Chestnut and Futura was legally valid and binding in light of the landmark decision of the Supreme Court of the Commonwealth of Puerto Rico in *Enrique Campos del Toro, et al.* v. *American Transit Corp., et al.*, 82 JTS 128 (1982). The Court rejected Futura's attack on the commercial transaction which we have heretofore described by quoting from *Campos del Toro* that:

> "...in the commercial field there are aleatory and imponderable elements capable of turning a legal agreement into a bad business venture".

Futura filed a Motion for Reconsideration which the trial court denied. Futura agreed for the first time in this motion that the segregation of the Section 1 of the property and the release thereof from the $1.4 million note was null and void. The trial court did not entertain the motion for reconsideration. Futura then filed an application in the Supreme Court of Puerto Rico seeking review of the judgment entered below. On January 27, 1983, the Supreme Court affirmed. It is against this factual background that we now analyze the legal issues raised in the present case.

III.

Legal Analysis

I. *Securities Claims*

The defendants have moved to dismiss the claims presented pursuant to the Securities Act of 1933 and the Securities Exchange Act of 1934. For ease of reference we will refer to the "1933 Act" and the "Exchange Act", respectively.

Futura avers that defendants have violated the 1933 Act and the Exchange Act, in particular Section 10b of the latter, Section 17(a) of the 1933 Act and Rule 10b-5 of the Securities Exchange Commission. 15 U.S.C. § 77q(a), 78j(b). 17 C.F.R.

§240 10b-5. Futura avers that a fraud was committed by defendants in that they deceived Futura "by never intending to pay the Purchase Money Note" delivered to Futura at the time of the purchase of certain property described in the complaint. Futura then avers that defendants later refused to pay the first installment on the Note when due.

A. *Statute of Limitations*

Defendants first raise the defense that the statute of limitations bars any action under the securities laws. The parties are in agreement that, following *Valles Salgado* v. *Piedmont Capital Corp.*, 452 F.Supp. 853 (D.C. P.R. 1978) and *Salgado* v. *Piedmont Capital Corp.*, 534 F.Supp. 938 D.C. P.R. 1981), the applicable statute of limitations is two years. The limitation period begins to run "on the date that the illegal action is or should have been discovered". *Salgado*, *supra*, at 947.

Futura filed suit on March 26, 1982. However, the first installment on the Note (issued on April 10, 1975) became due on February 1, 1979 and defendant 111 E. Chestnut Corp. ("Chestnut") did not pay. Defendant's failure to pay starts the running of the statute unless Futura can show that it used due diligence to uncover fraud and was thwarted by fraudulent concealment by defendant. See *Cook* v. *Avien*, 573 F.2d 685 (1 Cir. 1978); *Campbell* v. *Uphjohn Co.*, 498 F.Supp. 722 (W.D. Mich. 1980) affd. 676 F.2d 1122 (6 Cir. 1982); *Verrechia* v. *Paine, Webber, Jackson & Curtir*, 673 F.Supp. 360 (D.C. P.R. 1982); *Long* v. *Abbott*, 459 F.Supp. 108 (D. Conn. 1978).

Futura's averments and supporting affidavit show that it knew or should have known, since early 1979 at the latest, of the allegedly wrongful acts of defendants. It was clear to Futura, since 1975 according to the affidavit and averments, that its sole guarantee of payment was its lien on Section 2 of the property and that Chestnut was not liable for any deficiency. The non-recourse note was signed and later liberation of Section 1 from the mortgage was obtained pursuant to the

agreements. When Chestnut defaulted in February of 1979, Futura knew or should have known all of the operative facts of any alleged scheme. The pleadings do not allege fraudulent concealment nor are any facts averred from which such an inference might be derived.

Accordingly, Futura's failure to rebut the limitations defense merits dismissal of the securities claims contained in the pleadings.

B. *Is the PM Note a Security?*

Defendants raise a further question under the securities laws, one that has been answered in more than one way by federal district courts and courts of appeal in various circuits. Defendants argue that the only possible "security" in this case is the PM Note, that the PM Note is not a "security" within the meaning of the securities laws and that, therefore, the complaint fails to state a claim pursuant to those laws and fails to confer subject matter jurisdiction over those claims.

We begin by noting that the statutory definitions of "security" in both the 1933 Act and the Exchange Act specifically include "any note". Section 2(1) of the 1933 Act and Section 3(a)(10) of the Exchange Act; 15 U.S.C. §§77b(1), 78c(a)(10). However, the context may require disregard of the literal language of the definition and courts have so recognized when interpreting the definitions contained in the securities laws. *United Housing Foundation, Inc.* v. *Forman*, 421 U.S. 837, 848 (1975), *reh'g denied*, 423 U.S. 884 (1975).

A participation or interest in property may or may not be a "security" depending on a number of factors even though it might be within the literal statutory definition. Thus, for example:

—stock in a nonprofit housing cooperative is not a security. *United Housing Foundation, Inc.* v. *Forman*, *supra*.

—an employee's interest in a compulsory noncontributory pension plan is not a security. *Int'l Brotherhood of Teamsters* v. *Daniel*, 439 U.S. 551 (1979).

—a certificate of deposit issued by a bank is not a security. *Marine Bank* v. *Weaver*, 455 U.S. 551 (1982).

A number of federal courts have held that many notes are not securities, although they are within the literal definition. *E.g. C.N.S. Enterprises, Inc.* v. *G&G Enterprises, Inc.*, 508 F.2d 1354 (7th Cir. 1975), *cert. denied*, 423 U.S. 825 (1975); *McClure* v. *First National Bank*, 497 F.2d 490 (5th Cir. 19), *reh'g denied*, 502 F.2d 1167 (1974), *cert. denied*, 420 U.S. 930 (1975); *Emisco Industries, Inc.* v. *Pro's, Inc.*, 543 F.2d 38 (7th Cir. 1976). See also, "Annot. Promissory Notes as Securities", 39 A.L.R. Fed. 357 (1978).

The federal courts have used three avenues of analysis to determine whether a particular note is a "security" covered by the securities laws. These three have been called: 1) the commercial-investment dichotomy approach; 2) the risk capital approach; and 3) the literal approach. The first is used by the Third, Fifth, Seventh and Eleventh Circuits.[2]

Although our own First Circuit has not ruled on the precise issue, decisions in analogous cases by the Court of Appeals and district courts have used the commercial-investment dichotomy analysis. In *SEC* v. *World Radio Mission, Inc.*, 544 F.2d 535 (1st Cir. 1976) disapproved on other grounds in *Aaron* v. *SEC*, 446 U.S. 680 (1980) a religious organization offered a large number of small denomination notes to the public, specifically, for the purpose of investment. The court cited the

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[2] See *Lino* v. *City Investing Co.*, 487 F.2d 689 (3rd Cir. 1973); *Williamson* v. *Tucker*, 645 F.2d 404 (5th Cir. 1981), *cert. denied*, __ U.S. __ (1981); *Emisco Industries* v. *Pro's, Inc.*, 543 F.2d 38 (7th Cir. 1976); *Zabriskie* v. *Lewis*, 507 F.2d 546 (10th Cir. 1974); *Kaye* v. *Pawnee Construction Co., Inc.*, 680 F.2d 1360 (11th Cir. 1982). See also: *Thorp Commercial Corp.* v. *Northgate Industries, Inc.*, __ F.Supp. __, Fed. Sec. L. Rep., par. 94, 929 (D.C. Minn. 1974).

investment purpose in holding that the notes were securities. In *Manchester Bank* v. *Connecticut Bank & Trust Co.*, 497 F.Supp. 1304 (D. N.H. 1980), the court held that loan participations between commercial banks were not securities, basing its opinion on the "investment contract" analysis of *United Housing Foundation, Inc.* v. *Forman*, 421 U.S. 837, and *Securities and Exchange Commission* v. *W. J. Howey Co.*, 328 U.S. 293 (1946), *reh'g denied*, 329 U.S. 819 (1946). The *Manchester* court also cited approvingly cases utilizing the commercial-investment test with respect to notes.

The underlying premise of the commercial-investment test is that the securities laws are for the protection of investors (a phrase that appears throughout both Acts, *e.g.*, Securities Exhange Act § 10(b), 15 U.S.C. § 78j; under which Futura is suing and under which Rule 10b-5 is issued) but not for the protection of participants in ordinary commercial transactions. It follows that an investment is a security but a commercial note is not.

In distinguishing commercial from investment notes, the courts have typically considered these factors:

(i) Was the note given or taken in an ordinary type of commercial or business transaction?

(ii) Was the note a cash substitute? This indicates commercial rather than investment. This also has independent significance because "currency" is explicitly excluded from the "security" definition of Securities Exchange Act § 3(a)(10), 15 U.S.C. § 78c(a)(10).)

(iii) Was the transaction negotiated privately or was the note offered to the public? The former indicates commercial, the latter investment. The Supreme Court has just given strong, perhaps conclusive and independent significance to this factor in holding that a profit sharing arrangement was not a "security". It stressed the difference between a publicly offered instrument and "a private transaction", and

> ended by stating "we hold that this unique agreement, negotiated one-on-one by the parties, is not a security". *Marine Bank* v. *Weaver*, 455 U.S. at 560 (1982), 71 L.Ed.2d at 417 (1982).

The sale of property is a quintessential commercial transaction, especially when the buyer and seller are both business corporations and large amounts of money are involved. The cases which have dealt with property purchase money notes have held them, without hesitation, not to be "securities".

A recent decision directly on point is *Williamson* v. *Tucker*, 645 F.2d 404 (5th Cir. 1981). When the owner of property sold it for promissory notes executed by the purchasers, the court held the notes were not "securities":

> The notes issued by [purchasers of the property] were real estate purchase money notes given to the [sellers of the property] in exchange for the property. . . [T]he purpose of the note transaction was to *finance* the sale of the property, not to sell *investments* to [sellers of the property]. . . In essence, the (property sellers) facilitated their sale of the property by themselves loaning the purchase price to the [property purchasers] and accepting general liability notes secured by the property as evidence of such debts. . . We hold, therefore, that the promissory notes executed by the [property purchasers] are commercial in nature and, as a matter of law, are not securities within the meaning of the [Securities Acts]." *Williamson* v. *Tucker*, 645 F.2d 428-29 (emphasis in the original).

See also: *Oliver* v. *Bostetter*, 426 F. Supp. 1082 (D. Md. 1977); *Emisco Industries, Inc.* v. *Pro's, Inc., supra*; *Lino* v. *City Investment Co., supra*; *Altman* v. *Knight*, 431 F. Supp. 309 (S.D. N.Y. 1977); *Sea Pines of Virginia, Inc.* v. *PLD., Ltd.*, 399 F. Supp. 708 (M.D. Fla. 1976); *Van Arsdale* v. *Claxton*, 391 F. Supp. 538 (S.D. Cal. 1975).

It is clear that the note at bar is commercial, hence not a "security". It is nothing more than a cash substitute for part of the purchase price of commercial property sold by Futura. Acceptance of the note in lieu of cash was more in the nature of a loan of the purchase money to Chestnut than an investment in the note. *Emisco Industries, Inc.* v. *Pro's, Inc.*, 543 F.2d at 40. In economic reality, the transaction was clearly commercial in nature. *Williamson* v. *Tucker*, 645 F.2d at 429. It was a "unique agreement, negotiated one-on-one by the parties". *Marine Bank* v. *Weaver*, 455 U.S. at 560, 71 L.Ed.2d at 417. Moreover, it was negotiated between business corporations, carefully documented, and fully agreed to, as is apparent from the face of the note, the mortgage and the deposition referred to in the Superior Court's Opinion. Although the note was not issued by a third party, it is similar in many respects to notes delivered in commercial financing. *Altman* v. *Knight*, 431 F.Supp. at 312.

To hold that the note in the present case is a security would tend to bring almost all commercial real estate transactions within the federal securities laws. This would be an untenable expansion of the jurisdiction of federal courts. *Van Arsdale* v. *Claxton*, 391 F.Supp. at 541. As stated in *Union Planters National Bank of Memphis* v. *Commercial Credit Business Loans, Inc.*, 651 F.2d 1174, 1185 (6th Cir. 1981) *cert. denied*, 454 U.S. 1124, 102 S.Ct. 972 (1981): "[t]he security laws are not a panacea for commercial loans gone awry". This is in accord with the Supreme Court's recent statement: "Congress, in enacting the securities laws, did not intend to provide a broad federal remedy for all fraud". *Marine Bank* v. *Weaver*, 455 U.S. at 556, 71 L.Ed.2d at 415.

The "literal" approach espoused only by the Second Circuit, as well as the risk capital approach articulated by the Ninth and Tenth Circuits seem to be at odds with the reasoning of the Supreme Court in subsequent cases such as *Forman*, *supra*, particularly at pages 848, 857, n. 24. In the case at bar,

moreover, the PM Note would not be deemed a security under any of the three tests. It is not evidence of an investment. It is not covered by the "literal" approach as articulated in *Exchange National Bank of Chicago* v. *Touche Ross & Co.*, 544 F.2d 1126 (2d Cir. 1976), at 1138. Moreover, it is not evidence of "risk capital" subject to the entrepreneurial or managerial efforts of others. See *Union Planters National Bank of Memphis* v. *Commercial Credit Business Loans, Inc.*, 651 F.2d 1174 (6th Cir. 1981), *cert. denied*, 455 U.S. 1124; *Amfac Mortgage Corp.* v. *Arizona Mall of Temple, Inc.*, 583 F.2d 426 (9th Cir. 1978); *Great Western Bank and Trust Co.* v. *Kotz*, 532 F.2d 1252 (9th Cir. 1976).

Since liability under either Section 17(a) of the 1933 Act or Section 10b of the Exchange Act can exist only if the disputed transaction involves a "security", and since the PM Note is not a "security", the claim for relief under the securities laws should be dismissed even had it not been time-barred.

C. *Misrepresentation — Materiality*

Concerning the issue of misrepresentation or failure to disclose, Futura does not deny that both the PM Note and the Mortgage expressly stated that Chestnut would have no personal liability. It is uncontroverted that, from the very beginning in 1975, Futura's security was to be limited to Section 2 of the property. The fact that Chestnut was, as a matter of right, entitled to segregate Section 1 and obtain from Chestnut the release of its $1.4 million lien from Section 1, without further consideration, evidences that this was the intention of the parties. The non-personal liability clause contained in the $1.4 million note and mortgage confirms it.

In return, Futura received from Chestnut a cash payment of $1,300,000. Chestnut also assumed a first mortgage of $1,800,000.00. This was the bargain price between the parties. This is hardly the stuff of which securities claims are made.

All of the essential facts and risks were known to both parties, particularly to the seller, Futura. In essence, Futura sold a portion of its property at a reasonable price and retained a lien (whose priority was later improved) on the remaining portion, with full awareness of all risks and benefits. The language in the Note and in the mortgage is explicit and unambiguous. Accordingly, Futura's claims under the securities laws must be denied for failure to state a claim upon which relief can be granted.

D. *Section 17(a) Claim*

Finally, it seems clear that there is no private right of action under section 17(a) of the 1933 Act. *Kaufman* v. *Magid*, 539 F. Supp. 1088, 1097-98 (D. Mass. 1982); *Manchester Bank* v. *Connecticut Bank and Trust Co.*, 497 F. Supp. 1304, 1314 (D. N.H. 1980); *Dyer* v. *Eastern Trust & Banking Co.*, 366 F. Supp. 890, 903-05 (D. Me. 1971). See also *Salgado* v. *Piedmont Capital Corp.*, 534 F. Supp. 938 (D. P.R. 1981).

E. *Claims Controlled by Res Judicata and Collateral Estoppel.*[3]

We turn now to the question of whether the remaining claims should be dismissed on the grounds of res judicata or collateral estoppel by judgment. As noted earlier in our opinion, Futura, approximately two years before the filing of

[3] In view of recent developments in the doctrine of *res judicata* as it applies to preclusion of federal claims over which the federal courts have exclusive jurisdiction, it would seem that plaintiff may not prosecute its securities claims before this court. *See, e.g. Marrese* v. *American Academy of Orthopedic Surgeons*, 81-2671, 52 U.S.L.W. 2397 (7th Cir., January 3, 1984). (Plaintiffs held foreclosed from asserting federal antitrust claims which they failed to advance against defendants under state antitrust laws in prior state court litigation); *Derish* v. *San Mateo-Burlingame Board of Realtors*, 83-1791, 52 U.S.L.W. 2409-2410 (9th Cir., December 23, 1983). (Plaintiff losing state lawsuit under state antitrust laws patterned after Sherman Act, held barred from re-litigating same claim in Federal District Court under Sherman Act).

The securities laws, much the same as the federal antitrust laws, confer exclusive jurisdiction on the federal courts to adjudicate claims arising under

the present complaint, had sought to collect from Chestnut in the state courts on the same note of $1.4 million which forms part of the controversy in the instant case. Also, Futura attempted to set aside the non-recourse provision contained in the note and in the mortgage securing the obligation and, further, to foreclose the mortgage and the cancellation of another mortgage lien of $700,000 which was superior in rank to its mortgage lien. While Chestnut's and Futura's cross motions for summary judgment were pending resolution before the Superior Court, the present complaint was then lodged against Chestnut and thirteen other codefendants.

Chestnut argues that Futura cannot now prosecute its claims relating to fraud, damages, breach of contract and alter egos because it should have litigated them in the Superior Court. Having failed to do so, Chestnut asserts, this Court must dismiss them on the grounds of res judicata or collateral estoppel.

Futura's response is that this case is completely different from the Superior Court case, because it involves different parties, different facts and legal issues, and different causes of action. Therefore, Futura states that it was completely free to come before this forum to litigate these different claims.

We cannot agree with Futura's narrow reading of the principles governing the application of res judicata. This legal rule is precisely designed to prevent what Futura is trying to do

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them, *Will* v. *Calvert Insurance Co.*, 437 U.S. 655, 666 (Plurality opinion by Justice Rhenquist), & 670 (Justice Brennan, dissenting) (1978). Puerto Rico, however, has antitrust securities provisions similar to those found in the federal securities laws invoked by plaintiff in this case. Compare 10 L.P.R.A. with 15 U.S.C. 78j(b). This state securities laws could have but were never pleaded, by plaintiff Futura in state court. It follows then that Futura should be precluded from advancing these claims in this court under the guise of federal securities violations. This result would seem even more compelling here in view of the absence of any need for uniform and expert construction of federal law by this court given the purely local real estate overtones of the commercial transactions serving as background to the complaint. See, text, *supra*, at 5-11.

here. As it has been repeatedly stated, the plea of res judicata arises from the necessity of putting an end to litigation, *Buscaglia, Treasurer* v. *Tax Court*, 72 P.R.R. 576, 580 (1951); *Zambrana* v. *Tribunal Superior*, 100 D.P.R. 179, 181 (1971); to avoid the hardship of subjecting a party to the successive filings of various suits related to the same matter, *Cruz* v. *Ortiz*, 82 P.R.R. 802 (1961); *Zambrana* v. *Tribunal Superior, supra*; *Lausell Marxuach* v. *Diaz de Yanez*, 103 D.P.R. 533 (1975); *Pagan Hernandez* v. *U.P.R.*, 107 D.P.R. 720 (1978), and to protect the State's interest in concluding litigations, as well as to impart Court's decisions with due dignity. *Perez* v. *Bauza*, 83 P.R.R. 213, 217 (1961); *Pagan Hernandez* v. *U.P.R., supra*.

Even if we were to accept Futura's version that it learned about the alleged fraud in September or October, 1981, under Puerto Rico law it still could have moved to amend its complaint in the Superior Court to include the new causes of action.[4] There was nothing to prevent Futura from amending its complaint to bring the same issues and joining the same defendants in the Superior Court which are now present in this Court. Cf. Rules 13.1, 13.4, and 18, Puerto Rico Rules of Civil Procedure. Futura, however, continued prosecuting its litigation there as if nothing had happened. In fact, eight months after the alleged fraudulent and conspiratorial scheme allegedly surfaced, it moved for summary judgment relying on a set of uncontroverted facts which are in direct conflict with those that are being alleged by Futura in the present complaint. The splitting of actions by Futura runs counter to the law which states that "...the doctrine of res judicata prevents the litigation in a suit of a claim that could have been litigated and adjudicated in a previous suit between the same parties and about the same cause of action". *Mercado Riera* v. *Mercado Riera*, 100 D.P.R. 940, 950 (1972) and cases cited therein.

[4] On February 1, 1982, the law firm of Mr. Harry Woods, the same attorneys of Futura in the instant case, had informed the Superior Court that they had joined Futura's legal representation.

Futura argues that res judicata is inapplicable here because the parties in the Superior Court litigation are different from those present before this Court.[5] We have pointed out earlier that res judicata forbids the splitting of actions which is what Futura has done. It could have amended its complaint and brought into the Superior Court lawsuit the other codefendants which are being sued here. Nevertheless, Futura's argument that the parties in the two lawsuits are not identical is defeated by its own legal theory propounded in the case. If we assume, as we must, that the pleaded averments are true for the purpose of this present motion, Futura's posture is that Chestnut and the thirteen codefendants are joint tortfeasors because all of them conspired to damage it through the alleged fraudulent and conspiratorial scheme. Article 1204 of the Civil Code, 31 L.P.R.A. 3342, in its pertinent part precisely provides that:

> "It is understood that there is identity of persons whenever the litigants of the second suit are legal representatives of those who litigated in the preceding suit, or *when they are jointly bound with their* obligation to satisfy the same." (Emphasis supplied).

The assertion made by Futura that all codefendants are alter egos of Centex Corporation would make the fourteen codefendants jointly and severally liable to it for the alleged damages contained in the complaint. Therefore, its theory triggers the application of the above-cited provision which stands for the proposition that there is identity of parties when the defendants would be "jointly bound" to satisfy the judgment which might be rendered against them. See, *Nesglo, Inc.* v. *Chase*, 562 F.Supp. 1029, 1038-1040 (D.C. P.R. 1983) and *authorities cited.*

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[5] Futura places heavy reliance on the substantive law in Puerto Rico that "In order that the presumption of res judicata may be valid in another suit, it is necessary that between the case decided by the sentence and that in which the same is invoked, there be the most perfect identity between the things, causes, and persons of the litigants and their capacity as such". 31 L.P.R.A. 3343.

Futura next contends that the fraud allegations here are different from the causes of action litigated and adjudicated in the Puerto Rico courts. Futura, in effect, is setting forth here different theories to attack the same commercial transaction which was sustained by the Superior Court and affirmed by the Supreme Court of Puerto Rico. As noted earlier, Futura in its Motion for Reconsideration asserted that the segregation and release transactions were invalid, arguments which the Superior Court did not entertain. The same arguments were unsuccessfully raised before the Supreme Court. Having failed there, it wants to have a second chance in this Court. This cannot be allowed. Precisely, the causes of action alleged herein, other than count seven of the complaint, arise from the same set of uncontroverted facts pleaded by the parties in their motions for partial summary judgment in the Superior Court. Counts 2, 3, 4, 5, 8, 9, and 10 relate to the specific commercial transactions which both parties relied upon to argue that there were no contested issues of fact that would preclude the Superior Court from entering partial summary judgment.

In *Vazquez Prada* v. *Santos*, 54 P.R.R. 57 (1939), the Supreme Court addressed a similar situation by saying that:

> "When the identity of parties and of action exists, but the reason to ask the nullity varies, the defense of res judicata must be sustained. The plaintiff who starts a suit is under obligation to set forth all his rights to avoid the inconveniences resulting if each and every one of the reasons or causes that the actor knew and might have alleged to ask for the nullity of the judgment are considered as distinct and independent actions. The introduction of a new rule might bring in uncertainty and chaos in business and would make impossible the establishment of steady and reliable jurisprudence.
>
> The mere fact that the present suit is brought on a different theory amounting to a new cause of action would not alter the situation." (Citations omitted).

In *Heirs of Rivera* v. *Lugo*, 63 D.P.R. 13 (1944) the Court affirmed the dismissal of the complaint on grounds of res judicata. Although the Court accepted that the second action alleged a different ground for the alleged nullity of the foreclosure proceeding, it explained that, nevertheless, res judicata precluded the second suit because "...a different mode of pleading does not constitute a new cause of action and we have repeatedly held that "a judgment on the merits in a former suit between the same parties, on the same cause of action,...operates as a bar to every matter which might with propriety have been litigated and determined in that action."

In *Bolker* v. *Tribunal Superior*, 82 P.R.R. 785 (1961), the Supreme Court extended the rule by stating that "Even if the alleged grounds for nullity would have been different, where the object of the action is the same, plaintiffs cannot prevail."

There are also alternate grounds to dismiss the remaining claims on the grounds of collateral estoppel. This judicial doctrine states that:

> "When an essential fact for the pronouncement of judgment is actually litigated by a valid and final judgment, such determination is conclusive between the same parties although different causes of action are involved".

See *Pereira* v. *Hernandez*, 83 P.R.R. 156, 161 (1961), *Long Corporation* v. *District Court*, 72 P.R.R. 737 (1951).

We have indicated that Futura's position before the Superior Court was that the promissory note of $1.4 million had been negotiated in its favor by Chestnut and that a deed of mortgage had been given by Chestnut to secure payment of the note. The parties to the transaction had also agreed that there would be no personal liability if Chestnut failed to pay. Futura also took the position that pursuant to the contractual commitments of the deed of mortgage, Chestnut was entitled to segregate a portion of the land which had been securing the note. It also recognized that at Chestnut's request, Futura

would liberate the segregated portion of the land and that it would subordinate its mortgage to other liens.[6] Futura then moved for summary judgment on these facts even when, it alleges, that it had already discovered the fraud eight months earlier. The judgment rendered by the trial court rested on the findings that this had been the commercial and contractual considerations of the parties. In this vein the Superior Court concluded that:

> "In the present case the agreement which limits the liability of debtor, here Chestnut, with its creditor, Futura, was clearly stated in the promissory note and mortgage deed constituted in order to guarantee the debt. From a deposition submitted by Chestnut in support of its motion it appears that said Agreement was amply discussed by the representatives of both parties to the contract including the attorneys of Chestnut and Futura. The clause that limits the liability of debtor was so important to Chestnut that Mr. Morris Solomon, deponent, testified that the referred agreement was essential to the negotiation. The agreement was discussed and Futura contracted with Chestnut acknowledging that it would never be personally responsible for such debt. As our Supreme Court stated in the aforementioned case *Campos del Toro*, supra, at pages 7 and 8:
>
> > 'in the commercial field there are aleatory and imponderable elements capable of turning a legal agreement into a bad business venture'.
>
> The covenant limiting responsibility and the other concomitant agreements, as: (a) segregation of property; (b) the release of mortgage to be executed by Futura of the segregated property; and (c) the release and subordination of its mortgage agreed and stipulated indicates that

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[6] As noted before, the Futura mortgage would be subordinated to the $700,000 lien on the remnant portion of the segregated land.

> since mortgage deed and promissory note were executed in the year 1975, the parties contemplated and acknowledged that the liability of Chestnut would be limited to the property that now guarantees the credit which Futura holds. This was the commercial agreement which Futura entered into."

After the Superior Court issued its opinion and judgment on December 3, 1982, Futura moved for reconsideration which the Court denied. It then filed a request for revision with the Supreme Court and the Supreme Court affirmed on January 27, 1983. While it was prosecuting its case, Futura never disclosed to the trial court or, for that matter to the Supreme Court, that it had been the victim of the alleged fraud. Futura now seeks relief here by formulating a set of different and contradictory factual grounds. The facts adjudicated by the Superior Court are conclusive and Futura cannot relitigate them here.

F. *Other Issues*

We need not reach, in view of the preceding, the arguments as to the sufficiency of the averments as to fraud concerning a number of defendants pursuant to Rule 9(b) F.R.C.P. Suffice it to say that the pleadings leave much to the imagination as to most of the defendants. Since we have determined that the securities claims must be dismissed on more substantive grounds, we will not discuss further the deficiencies of the pleadings as to particularity.

We also find it is unnecessary to reach the *in personam* jurisdictional arguments raised by defendants. Since all claims against all defendants in this action are defective as a matter of law, and can be fully disposed of on the grounds previously advanced in this opinion, nothing would be gained by a lengthy discussion of these jurisdictional issues. We do note, however, that a cursory examination of the arguments advanced reveals that they do have merit.

Defendant's motion to dismiss is granted and the complaint is hereby dismissed with prejudice.

Accordingly, the Clerk shall enter judgment in favor of the defendants, dismissing the complaint as to each of them.

In San Juan, Puerto Rico, this 30th day of March, 1984.

(s) JAIME PIERAS, JR.
JAIME PIERAS, JR.
U.S. District Judge

IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF PUERTO RICO

CIVIL NO. 82-0729 (JP)

FUTURA DEVELOPMENT CORP. OF PUERTO RICO, INC.,
PLAINTIFF(S)

v.

CENTEX CORPORATION, ET AL.,
DEFENDANT(S).

JUDGMENT

Pursuant to the Memorandum Opinion dated March 30, 1984 granting defendant's Motion to Dismiss, the Court hereby enters JUDGMENT DISMISSING the Complaint.

SO ORDERED AND ADJUDGED.

In San Juan, Puerto Rico, this 30 day of March, 1984.

(s) JAIME PIERAS, JR.
JAIME PIERAS, JR.
U.S. District Judge

APPENDIX B

United States Court of Appeals
For the First Circuit

No. 84-1372

FUTURA DEVELOPMENT CORPORATION,
PLAINTIFF, APPELLANT,

v.

CENTEX CORPORATION, ET AL.,
DEFENDANTS, APPELLEES.

APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF PUERTO RICO
[HON. JAIME PIERAS, JR., *U.S. District Judge*]

Before

COFFIN, *Circuit Judge*,
WISDOM,* *Senior Circuit Judge*,
and BOWNES, *Circuit Judge*.

Harry E. Woods with whom *Geoffrey W. Woods* and *Woods and Woods* were on brief for appellant.

Jay A. Garcia-Gregory with whom *Francisco De Jesus Schuck*, *Salvador Antonetti-Zequeira*, *Maria Del Carmen Taboas*, *Fiddler, Gonzalez & Rodriquez*, *Marshal Simmons, P.C.* and *Jenkens & Gilchrist* were on brief for appellees.

April 30, 1985

* Of the Fifth Circuit, sitting by designation.

BOWNES, *Circuit Judge.* Appellant-plaintiff, Futura Development Corporation, claims that Centex Corporation and various of its subsidiaries, officers, and directors defrauded it of payment on a promissory note and seeks to recover its losses via §10(b) of the Securities Exchange Act of 1934 and its implementing Rule 10(b)(5), 17 C.F.R. §240.10b-5 (1984); §17(a) of the Securites Act of 1933; and Puerto Rico law. The district court dismissed Futura's suit, finding that: its fraud claims were barred by the statute of limitations; the promissory note was not a security within the context of the federal securities laws; §17(a) of the Securities Act of 1933 did not provide a private cause of action; the misrepresentation by Chestnut Corporation, a subsidiary of Centex, if any, was not material; and that Futura could have and should have brought, at least, the commonwealth law fraud claims in its prior commonwealth court action and is now barred by res judicata and collateral estoppel from litigating them in federal court. We affirm the district court's decision on the grounds that the plaintiff's claim does not come within the ambit of the federal securities laws and that the Puerto Rico law claims are barred by res judicata.

I. FACTUAL SETTING

This is a tale in which, at every stage in the action, the plaintiff has proved to be its own worst enemy. The factual origins of this case date back to early 1975 when Futura, a Puerto Rico real estate development company, entered negotiations with Chestnut, a wholly owned subsidiary of Centex, to sell a tract of land suitable for the development of residential units in Rio Grande and Canovanas, Puerto Rico. Chestnut originally offered to buy a portion of the land (hereinafter referred to as Section One) consisting of approximately 108.0671 cuerdas (about 100 acres) for $1.3 million, but Futura refused to sell the portion separately because the tract was worth more as a whole than it would have been if subdivided. Thereafter, in April of 1975, Futura and Chestnut

entered into a sales agreement of the whole tract for $4,584,713.70. The sale was structured so that Futura received the purchase price in three ways: $1.3 million was paid in cash at the time of the sale; Chestnut assumed a mortgage that Futura had previously taken on the tract for $1.8 million; and Chestnut gave Futura a promissory note for the remaining $1.4 million secured by a mortgage on the property.

A. *The Sales Agreement*

The note provided that Chestnut would pay the principal plus 9% annual interest in two installments. The first installment of $742,356.85 was payable approximately four years later, on February 1, 1979, and the remaining $742,356.85 was payable the following year on January 31, 1980. The note provided that if Chestnut failed to pay the principal and interest and did not cure the default within thirty days, Futura could accelerate the unpaid balance. The note also provided that *Chestnut was relieved of all personal liability on the note* and that Futura or any subsequent holder would never institute proceedings or actions to enforce personal liability against Chestnut. Although not collectible in a personal action, the note was secured by a mortgage.

The mortgage agreement, obviously executed with a view towards Chesnut's development and eventual resale of the property, gave Chestnut the right to periodically procure releases of portions of the property from the mortgage. Futura agreed to release Section One (the 108.067 cuerdas Chestnut originally sought to buy separately) without any further payment to Chestnut regardless of whether Chestnut was in default on the promissory note. Chestnut could seek release of the other portions of the property, consisting of five parcels ranging in size from seventeen to twenty-six cuerdas, in a specified order upon payment of approximately $16,825 per cuerda so long as Chestnut was not in default.

In the event of default, the mortgage agreement provided that the property subject to the mortgage could be foreclosed by summary proceedings. To facilitate foreclosure Chestnut waived reappraisal; the mortgage agreement declared that the property would be deemed to be worth the total amount for which the property was mortgaged at the time of foreclosure. The mortgage agreement stated, as the promissory note did, that Chestnut was never to be personally liable for any payment.

Finally, Futura agreed to subordinate its mortgage to a $10 million mortgage and $700,000 mortgage made out in bearer form so that Chestnut could obtain loans for the development and improvement of the property. The Futura-Chestnut mortgage agreement stated that any loan resulting from Chestnut's use of the superior bearer mortgage notes could be used only for development and improvement of the tract. The agreement also provided that if Section One were released Futura's mortgage would become superior to the bearer mortgages on the remainder of the property (hereinafter referred to as Section Two.)

B. *Default*

On February 1, 1979, Chestnut failed to pay the first installment due on the note. According to an affidavit of the Executive Vice-President of Futura, Futura, upon inquiry, was told that Centex and another of its subsidiaries would assume and guarantee payment. Futura was also allegedly told by two Centex codefendant employees that a check was in process. On February 9, 1979, Futura executed a release for Section one and its lien position on the remainder of the property was elevated pursuant to the mortgage agreement. On February 21, 1979, Chestnut paid off the $1.8 million note and retired the mortgage it had assumed at the time it bought the property from Futura. The upshot of the 1979 reshuffling was that Section One was encumbered by a first lien of $10 million and a second lien of $700,000 (the bearer mortgages). The remain-

der of the tract was subject to a first mortgage lien of $700,000, a second mortgage lien of $1.4 million (Futura's mortgage) and a third mortgage lien of $10 million.

February 1979 passed and the check that was supposedly in process never arrived. Futura again demanded payment by letter in March 1979 but received no satisfaction. In January 1980 Chestnut defaulted on the second installment of the promissory note due Futura.

C. *The Lawsuits*

A year and three months after the 1979 default (three months after the 1980 default) Futura filed suit against Chestnut and two unnamed agents of Chestnut in Puerto Rico Superior Court to collect the principal and interest due from Chestnut personally despite the nonliability provision and its promise not to institute court proceedings. In addition, Futura sought to foreclose on the mortgage and to set aside the $700,000 mortgage which was superior to it in rank.[1]

After the commonwealth lawsuit commenced, Futura and Chestnut/Centex conducted several suit-related negotiation meetings. During a meeting in October of 1981, Jack McDonald, President of Centex, informed the President of Futura that neither Centex nor Chestnut had ever intended to pay the balance of the purchase price. Futura claims it was at this point that the scales fell from its eyes and it first realized that in order to obtain Section One, Centex had only pretended to want to buy the entire tract. Despite this apparent revelation, Futura continued to press its commonwealth court action which was premised on the validity of the sales contract and mortgage agreement and made no attempts to amend its complaint or alter the focus of the action.

[1] Futura claimed that the $700,000 bearer mortgage should be set aside because the loan it secured had been provided by another Centex subsidiary to finance improvements on a farm that was located on Section One. Since Futura had released Section One it apparently felt, on some sort of marshalling theory, that the $700,000 mortgage should not apply to Section Two.

Meanwhile, on March 26, 1982, Futura filed suit in the United States District Court alleging various federal and commonwealth causes of action based on the contention that Chestnut and Centex had defrauded Futura of the unpaid balance of the sales price. On July 10, 1982, Futura cross-moved for summary judgment in the Puerto Rico Superior Court, seeking a determination that Chestnut was personally liable under the contract because personal nonliability provisions were against public policy.

On December 3, 1982, the Puerto Rico Superior Court held that the nonrecourse provisions in the mortgage agreement and promissory note were legally binding and that Futura's remedy was limited to foreclosure on Section Two of the tract. The Superior Court's judgment was affirmed by the Puerto Rico Supreme Court on January 27, 1983.

With the dimming of the lights on its contract action, Futura concentrated its energy on the claim of fraud before the district court.

II. PROCEDURAL CHALLENGES

In ruling on the motion for dismissal, the district court considered affidavits and papers apart from the pleadings and properly treated the motion as one for summary judgment. Fed.R.Civ.P. 12(b). Futura contends, however, that the district court considered Spanish language documents generated in the commonwealth foreclosure action in contravention of Rule 6 of the Local Rules of the Puerto Rico District Court which requires that all documents be translated into English unless the court otherwise orders. We reject this attempt to take advantage of a technicality. Futura does not deny that it participated in producing the documents, not does it deny that Spanish is its language of customary use and the native language of the judge that heard the case. *See Federal Deposit Insurance Corp.* v. *Coll Gonzalez*, 729 F.2d 46, 47 (1st Cir. 1984). Moreover, Futura did not complain about the absence

of translations until after the district court had rendered a judgment against them and translations were supplied by appellees less than three weeks later.

We have also considered Futura's claim that the district court judge should have recused himself from the case because of alleged personal bias against Futura's attorney and find it to be without merit.

III. THE FEDERAL SECURITY-NOTE CLAIMS

Futura claims that Centex represented, during the contract negotiations and in the promissory note that it intended to buy the entire tract when, in fact, it did not and that such representations constituted fraud in connection with the purchase and sale of a security. Centex argues, and the district court found, that the promissory note involved in this sale was not a "security" within the protection of the federal security laws.

In examining the question of subject matter jurisdiction over the federal securities claims the district court properly treated Centex's motion to dismiss as a motion on the merits rather than a 12(b)(1) motion to dismiss for lack of jurisdiction since the basis of jurisdiction was also an element of the plaintiff's cause of action. *Bell* v. *Hood*, 327 U.S. 678 (1975); *Williamson* v. *Tucker*, 645 F.2d 404, 415 (5th Cir.), *cert. denied*, 454 U.S. 897 (1981). In reviewing the district court's finding that there was no jurisdiction under the securities laws, we examine the record in the light most favorable to the party opposing the motion, indulging all inferences favorable to this party. *Williamson* v. *Tucker*, 645 F.2d at 416.

Discussion of the antifraud coverage of the securities acts necessarily begins with the definitions of "security" under the 1933 and 1934 Acts. Section 2(1) of the 1933 Securities Act and section 3(a)(10) of the Exchange Act of 1934 offer essentially identical definitions and provide:

> When used in this subchapter, unless the context otherwise requires—
>
> (1) The term "security" means any note. . . investment contract. . . or, in general, any interest or instrument commonly known as a "security."

15 U.S.C. §§77b(1); 78c(a)(10)(1982).[2] The only statutory limitation on the scope of the definition of security is an exemption for notes with a maturity of less than or equal to nine months that is contained in the 1934 Act. 15 U.S.C. §78c(a)(10). The note executed in the sale of the tract clearly comes within the literal language of the federal securities laws.

Nonetheless, the Supreme Court has held that the name given to an instrument is not dispositive, stating that "in providing definitions Congress did not attempt to articulate the relevant economic criteria for distinguishing securities from non-securities." *United Housing Foundation, Inc.* v. *Forman*, 421 U.S. 837, 847 (1975). In *Forman*, the Court declined to find shares of "stock" in a cooperative housing project that were purchased by tenants as a prerequisite to living in the cooperative and were redeemable for the price paid when the tenant vacated, to be "shares" or "investment contracts" within the meaning of the federal securities laws. The Court examined the substance of the transaction and determined that the purchasers were interested in procuring a place to live, not investing money in a common enterprise for profits resulting from the efforts of others. *Id.* at 852. *See also SEC* v. *W.J. Howey*, 328 U.S. 293, 302 (1946).

While *Forman* involved investment contracts rather than notes, it is now generally understood that courts must examine the substance of "economic realities" of all alleged securities

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[2] Despite occasional differences in wording, definitions of "security" contained in the 1933 Act and the Exchange Act of 1934 are treated as functionally equivalent. *See United Housing Foundation, Inc.* v. *Forman*, 421 U.S. 837, 847 (1975); *Ballard & Cordell Corp.* v. *Zoller and Dannenberg Exploration, Ltd.*, 544 F.2d 1059 (10th Cir. 1976), *cert. denied*, 431 U.S. 965 (1977).

transactions and not rely on the form of the instrument to determine whether the transaction falls within the ambit of the federal securities laws. *See Tcherepnin* v. *Knight*, 389 U.S. 332, 336 (1967); *Union Planters National Bank of Memphis* v. *Commercial Credit Business*, 651 F.2d 1174, 1180-81 (6th Cir. 1981); *SEC* v. *World Radio Mission, Inc.*, 544 F.2d 535, 537-38 (1st Cir. 1976). A number of courts of appeals have found that not all "notes" are securities although they are within the literal definitions of the Acts. *See, e.g., United American Bank of Nashville* v. *Gunter*, 620 F.2d 1108 (5th Cir. 1980); *Lincoln National Bank* v. *Herber*, 604 F.2d 1038 (7th Cir. 1979); *Emisco Industries, Inc.* v. *Pro's Inc.*, 543 F.2d 38 (7th Cir. 1976); *Great Western Bank & Trust* v. *Kotz*, 532 F.2d 1252 (9th Cir. 1976); *C.N.S. Enterprises* v. *G. & G. Enterprises, Inc.*, 508 F.2d 1354 (7th Cir.), *cert. denied*, 423 U.S. 825 (1975).

In determining the scope of the definition of "security" for purposes of the antifraud provisions of the security laws,

> we are guided by the familiar canon of statutory construction that remedial legislation should be construed broadly to effectuate its purposes. The Security Exchange Act quite clearly falls into the category of remedial legislation. One of its central purposes is to protect investors through the requirement of full disclosure by issuers of securities. . . .

Tcherepnin v. *Knight*, 389 U.S. 332, 336 (1967) quoting *SEC* v. *W.J. Howey Co.*, 328 U.S. 293, 298 (1946). Federal securities laws enacted for the purpose of protecting against fraud must be construed flexibly to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits. *SEC* v. *W.J. Howey Co.*, 328 U.S. at 299; *Woodward* v. *Metro Bank of Dallas*, 522 F.2d 84, 92 (5th Cir. 1975).

On the other hand, we do not believe that Congress intended that all business transactions involving notes be viewed as the purchase and sale of a security. Many note transactions involve

loan agreements, sales agreements, deeds of trust, mortgages, and personal security agreements which are governed by federal laws such as the Truth in Lending Act, 15 U.S.C. §1601 (1982), the Magnuson-Moss Warranty Act, 15 U.S.C. §45 (1982), and the antitrust laws and state laws such as the Uniform Commercial Code and state unfair and deceptive acts and practices statutes. Regulation of some note transactions, it is only logical to assume, should be left to the operation of these other laws. *See Woodward* v. *Metro Bank of Dallas*, 522 F.2d at 91. *Cf. Marine Bank* v. *Weaver*, 455 U.S. 551, 556 (1982) (certificates of deposit). Moreover, the securities laws involve elaborate registration and financial reporting requirements. While we do not believe that every security which may be subject to the antifraud provisions is necessarily a security for registration purposes, the expansion or contraction of the definition of security in one area certainly has ramifications for other areas of regulation. Obviously, subjecting the maker of every note to the reporting requirements of the 1933 Securities Act would paralyze the business community rather than assist in the free flow of capital as Congress intended. *Zabriskie* v. *Lewis*, 507 F.2d 546, 551 (10th Cir. 1974); *Bellah* v. *First National Bank of Hereford, Texas*, 495 F.2d 1109, 1114 (5th Cir. 1974). Thus, despite our firm support of the creative use of Rule 10b(5) and other antifraud provisions of the Securities Acts in thwarting fraudulent schemes, we recognize that there must be some limits on the scope of these provisions.

In assessing the economic realities of a transaction, different circuits have adopted varying approaches for determining whether a note is a security. The most widely adopted test is the "commercial vs. investment" test espoused by the Third, Fifth, Seventh and Eleventh Circuits and more or less employed in spirit in *Forman*. Under this test, the court looks to see whether a transaction more closely resembles typical investment situations or typical mercantile or commercial transactions to determine the applicability of the security laws. The "investment vs. commercial" approach focuses on the degree

to which the plaintiff is dependent upon the expertise and efforts of others. *See, e.g., Emisco Industries* v. *Pros Inc.*, 543 F.2d 38; *C.N.S. Enterprises* v. *G. & G. Enterprises*, 508 F.2d 1354; *Bellah* v. *First National Bank of Hereford, Texas*, 495 F.2d 1109.

The second test, developed by the Sixth and Ninth Circuits, focuses on whether the transaction more closely resembles a "loan" or has the risk factors associated with "risk capital." *See Union Planters National Bank* v. *Commercial Creditor*, 651 F.2d at 1182; *Great Western Bank and Trust Co.* v. *Kotz*, 532 F.2d 1252. This approach considers six factors: the length of time between the note's issuance and due date, whether there is collateral for the note, the form of the obligation, the circumstances of the issuance, the relationship between the amount borrowed and the size of the borrower's business, and the contemplated use of the proceeds. *Great Western Bank and Trust* v. *Kotz*, 532 F.2d at 1257-58.

The Second Circuit has developed what is referred to as the "literal approach." It interprets the language of the Securities Acts to require that the court presume that a "note" is a security and only exempts it from the Acts "if the context requires otherwise." In determining whether the context requires treatment of a note as a nonsecurity, the Second Circuit looks to see if the transaction at issue bears a strong "family resemblance" to transactions that it assumes were not intended to be covered by the securities laws. Transactions which the Second Circuit believes are clearly outside the Acts include: notes given in connection with home mortgages, consumer financing, short-term liens on small businesses, and short-term notes secured by accounts receivable. *See Chemical Bank* v. *Arthur Andersen and Co.*, 726 F.2d 930 (2d Cir.), *cert. denied*, 103 S. Ct. 253 (1984); *Exchange National Bank* v. *Touche Ross and Co.*, 544 F.2d 1126 (2d Cir. 1976). As might be expected, the conceptual basis of the three tests and the considerations examined by the courts in applying the tests tend to be very similar although the focus is slightly different.

While this court has not previously taken a formal position as to the most appropriate approach for determining if a note is a security under the securities laws, in *SEC* v. *World Radio Mission, Inc.*, 544 F.2d 535 (1st Cir. 1976), we focused on the transactional elements of a loan plan including "the character of the instrument given in commerce by the terms of the offer; the plan of distribution, and the economic inducements held out to the prospect."[3]

A. *The "Investment vs. Commercial" Focus is Most Appropriate*

The federal securities laws were enacted for the purposes of restoring investor's confidence in financial markets, *Marine Bank* v. *Weaver*, 455 U.S. at 555, reducing transaction costs associated with a caveat-investor rule, H.R. Rep. No. 1383, 73 Cong., 2d Sess. 4-5 (1934), and enhancing the free flow of capital, *Daily* v. *Morgan*, 701 F.2d 496, 500-02 (5th Cir. 1983). We believe that the investment/commercial test can best effectuate these purposes because it directly focuses on the investor's dependency on the efforts of others and the investor's dependency upon financial disclosures provided by the other party. Since the securities laws were designed to offer protection through disclosure, an assessment of the need for disclosure is obviously important in determining the need for coverage under the Acts. The risk capital approach focuses on the riskiness of the venture. Many investments, however, such as those involving markets in commercial paper are specifically designed to be low risk, yet such transactions were clearly intended by Congress to fall within the Acts. Moreover, the focus on the riskiness of the venture does not readily incorporate the disclosure needs of borrowers as well as lenders.

[3] In *Manchester Bank* v. *Connecticut Bank and Trust Co.*, 497 F. Supp. 1034 (D.N.H. 1980), the United States District Court for the District of New Hampshire surveyed the various circuits' approaches and applied the investment/commercial test to determine whether a loan participation agreement was a security within the Acts.

The "literal approach" adopted by the Second Circuit presumes coverage unless a transaction resembles a clear example of a nonsecurity. We must note, however, that the Supreme Court in the context of investment contracts and certificates of deposit has examined the positive indicia of investment rather negating a presumption of coverage. *See Marine Bank* v. *Weaver*, 455 U.S. at 556-59; *United Housing Foundation, Inc.* v. *Forman*, 421 U.S. at 856-60. Finally, the proposed official draft of the federal securities laws appears to endorse the investment/commercial approach by excluding from the definition of security a "note or evidence of indebtedness issued in a primarily mercantile or consumer, rather than investment, transaction not involving a distribution." ALI, *Federal Securities Code*, Proposed Official Draft §299.53(a), (b)(3) (1978). Thus, after considering the three judicial approaches for deciding whether a note is a security, we hold that the investment/commercial test is the most appropriate approach for determining whether a note comes within the protection of the securities laws.

In determining whether a note was given for investment rather than commercial purposes strong consideration must be given to: the size of the offering; whether there is, by necessity, reliance on the expertise of the issuer; the purpose of the issuer in executing the note and the payee in accepting the note; and the economic inducements held out to the prospect. *See Marine Bank* v. *Weaver*, 455 U.S. at 556; *Williamson* v. *Tucker*, 645 F.2d 404; *McClure* v. *First National Bank of Lubbock, Texas*, 497 F.2d 490, 493-94 (5th Cir. 1974) (en banc), *cert. denied*, 420 U.S. 930 (1975). Other considerations may also be relevant in a particular case such as: the degree to which the profit on the note is in the hands of the maker rather than the payee; whether the object of the holder was to acquire an interest in the property or enterprise; whether the note was primarily commercial because it was serving as a "cash substitute" for the purchase price; and whether the

return on the note was predetermined or could reasonably be anticipated, or was subject to the managerial efforts of the maker. *See, e.g., C.N.S. Enterprises, Inc.* v. *G. & G. Enterprises, Inc.*, 508 F.2d at 1360-62.

B. *Application to the Futura Note*

The facts strongly suggest that this note was generated in a commercial rather than an investment transaction. First, the note was given as a result of one-on-one business negotiations that culminated in a complicated "tailor made" sales agreement. This was not the type of offering that is typical of a securities transaction. Second, the note was for a definite amount with a predetermined rate of interest. In this respect the note served as a cash substitute for the sales price. Finally, the note's stated value was in no way dependent upon the entrepreneurial efforts of Chestnut, Centex, or any of their associated companies.

Because the note was only part of the loan transaction, we must also consider the terms of the mortgage agreement. Pursuant to the agreement, Futura took the note without personal recourse against Chestnut. The value of the land was the sole measure of Chestnut's legal obligation on the note. The value of the land which was artificially fixed by the mortgage agreement as the total amount for which the property was mortgaged, was the sole measure of Chestnut's legal obligation on the note. Thus the value of Futura's collateral depended, in part, upon the nature of the improvements made by Chestnut. Futura's agreement to subordinate its mortgage lien to construction and improvement mortgages heightened its dependence upon Chestnut's construction plan. This apparent reliance upon the efforts of others is some support for the claim that the note should be considered an investment security. To the extent, however, that Futura was "investing" in the property with the expectation that it would increase in value rather than merely seeking a repayment of the loan, it would

have gotten what it bargained for when the property was foreclosed on default of the note. Futura, therefore, would not have been defrauded by Centex's alleged plan not to pay the note.

If, on the other hand, as Futura strenuously argues, it did not view the value of the property as the measure of the value of the note, then the transaction was nothing more than a typical example of a seller assisting the buyer in purchasing real estate by offering a cash substitute financing plan. We do not believe that Congress intended run-of-the-mill real estate transactions to be governed by the Securities Acts. *See United Housing Foundation* v. *Forman*, 421 U.S. 837; *Williamson* v. *Tucker*, 645 F.2d at 429; *Altman* v. *Knight*, 431 F. Supp. 309 (S.D.N.Y. 1977); *Van Arsdale* v. *Claxton*, 391 F. Supp. 538 (S.D. Cal. 1975). Since we must assume for the purposes of review of the district court's dismissal that Futura's allegations of misrepresentation and reliance are true, we find that the note involved was not an investment security within the meaning of "security" in the 1933 and 1934 federal securities acts and, accordingly, affirm the dismissal of Futura's federal claims for lack of subject matter jurisdiction.

IV. STATE LAW CLAIMS

The district court dismissed Futura's commonwealth law fraud claims on the basis of res judicata and collateral estoppel.[4] Futura argues that under Puerto Rico law neither res judicata nor collateral estoppel apply because the parties, facts, legal issues, and causes of action alleged in the district court were not those decided in the Puerto Rico Superior Court action.

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[4] Centex argues that the federal security claims were also barred by res judicata. Because we have held that there is no federal subject matter jurisdiction over the securities claims, we need not determine whether Puerto Rico's res judicata statute would preclude claims that can only be brought in federal court. *See Marrese* v. *American Academy of Orthopaedic Surgeons*, 53 U.S.L.W. 4265, 4266-67 (U.S. Mar. 4, 1985)

Res judicata generally binds parties from litigating or relitigating any issue that was or could have been litigated in a prior adjudication and prevents claim splitting. *See Marrese* v. *American Academy of Orthopaedic Surgeons*, 53 U.S.L.W. 4265, n.1 (U.S. Mar. 4, 1985); *Capo Sanchez* v. *Secretary of the Treasury*, 92 P.R.R. 817 (1965); *Restatement (Second) of Judgments* §§ 18, 24 (1982). In Puerto Rico,

> the rule of res judicata is based on considerations of public policy and necessity: on the one hand, the interest of the State in terminating litigations in order that judicial issues may not be perpetuated . . ., and on the advisability of impressing court decisions with due dignity . . ., and on the other hand, the desirability of not submitting a citizen twice to the inconveniences which the litigation of the same cause entails.

Perez v. *Bauza*, 83 P.R.R. 213, 217-18 (1961).

P.R. Laws Ann. tit. 31, §3343, Puerto Rico's res judicata statute provides:

> In order that the presumption of the res adjudicata may be valid in another suit, it is necessary that, between the case decided by the sentence and that in which the same is invoked, there be the most perfect identity between the things, causes, and persons of the litigants, and their capacity as such.[5]

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[5] In addition, Puerto Rico's Code of Civil Procedure, P.R. Laws Ann. tit. 32, §1793 provides:

> The effect of a judgment or final order . . . before a court or judge of Puerto Rico, or of the United States, having jurisdiction to pronounce the judgment or order is . . . in respect to the matter directly adjudged, conclusive between the parties and their successors in interest by title . . . litigating for the same thing under the same title and in the same capacity, provided they have notice, actual or constructive of the pendency of the action or proceeding.

Article 1204 of the Civil Code [P.R. Laws Ann. tit. 31, §3343] and Article 42 of the Code of Civil Procedure [P.R. Laws Ann. tit. 32,

A. *Identity of Parties*

Futura first argues that res judicata cannot bar this case because §3343 requires a perfect identity of parties and the parties in the commonwealth court action are not identical to the parties in this action. Specifically, Futura was joined in the commonwealth court contract action by Woodville Company, an assignee of a partial interest in Futura's note. Woodville has not thrown its hat into the ring a second time. Futura also alleges that the federal action involves different defendants. In addition to the commonwealth court defendants (Chestnut and two unnamed individuals believed to be holders of the mortgage note), Futura has named Centex, the alleged parent of Chestnut; two other Centex subsidiaries; and eight individual codefendants who, while agents for Centex, committed one or more of the actions Futura alleges resulted in the fraud.

The literal language quoted by Futura appears to provide it with a toehold, but this is completely eroded by the subsequent provision of §3343 that Futura did not quote:

> It is understood that there is identity of persons whenever the litigants of the second suit are legal representatives of those who litigated in the preceding suit, or when they are jointly bound with them or by the relations established by the indivisibility of prestations among those having a right to demand them, or the obligation to satisfy the same.

Identity of parties and interest is required so that a party's rights and obligations will not be determined without their

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§1793]— reflect different legal traditions. The first is taken from Articles 1251 and 1252 of the Spanish Civil Code; the latter has its immediate origin in California. Nevertheless, the Supreme Court of Puerto Rico has expressly held in *Lausell Marxuach* v. *Diaz de Yanez*, 103 D.P.R. 533, 535 (1975), that "the doctrine of res judicata is . . . part of our Civil Law and except for comparative purposes we need not resort to other sources for its analysis."

Security Republic Corp. v. *Puerto Rico Aqueduct and Sewer Authority*, 674 F.2d 952, 955-56 n.4 (1st Cir. 1982).

knowledge or an opportunity for participation. There is no such danger here, for Futura was an active participant in the state court action. In *Republic Security Corp.* v. *Puerto Rico Aqueduct and Sewer Authority*, 674 F.2d 952, 955-59 (1st Cir. 1982), we found that under Puerto Rico law the assignee of a construction contract was precluded from litigating the validity of a contract that had previously been litigated by the assignor, In this case, the absence of the assignee, Woodville, in a subsequent suit by the assignor who was also party to the first suit presents even less justification for the avoidance of res judicata. To find otherwise would be to foster frivolous attempts at relitigation by parties whose previous colitigants are sensible enough to quit after the first adverse decision.

We also find unpersuasive Futura's claim that the addition of Centex and various of its subsidiaries and agents changes the parties in interest sufficiently to bar the application of res judicata. In *De Leon* v. *Colon*, 42 P.R.R. 21 (1931), the Puerto Rico Supreme Court held that the plaintiff could not relitigate after a suit had been determined by a final judgment although the plaintiff had joined additional defendants to the principal defendant in the second suit. In this case, we cannot see how the additional parties named in the fraud claims can be distinct defendants and also be potentially liable for the loss Futura claims to have suffered by entering the mortgage agreement with Chestnut. Clearly, whatever part Centex and its agents and subsidiaries played in defrauding Futura was undertaken through Chestnut; Futura has not alleged that it negotiated the note and mortgage/sales agreement with entities other than Chestnut. Indeed, the theory on which Futura posits the liability of Centex, et al. is an alter ego theory.[6]

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[6] The first cause of action alleged in Futura's complaint states:

> That upon information and belief, at all times . . . co-defendant Centex controlled, directly or indirectly co-defendant [Centex] Homes and S Corporation by means of stock ownership or otherwise and exclusively conducted, managed, dominated and controlled the business affairs of the other corporate co-defendants . . . as though they were not in effect

Futura cannot have it both ways, *i.e.*, claim liability on the basis of an alter ego theory while at the same time denying that the defendants have sufficient identity of interest to benefit from the commonwealth court's adjudication of Chestnut's obligations under the contract. Accordingly, we find that the parties in the commonwealth court action have sufficient identity of interest to be viewed as identical parties within the parameters of P.R. Laws Ann. tit. 31, §3343.

B. *Identity of "Things"*

Futura next argues that res judicata cannot be applied because this action does not involve the same "things" as the commonwealth court action. *See* P.R. Laws Ann. tit. 31, §3343. The requirement of perfect identity of "things" has been defined as "the object or matter over which the action is exercised." *Lausell Marxauch* v. *Diaz de Yanez*, 103 P.R.R. 533 (1975) (translation provided without page reference). We think it clear that in both actions the "object" was the contract and the "matter" was the validity of the contract and its provisions. Futura relies on *A & P General Contractors, Inc.* v. *Associacion Cana, Inc.*, 110 D.P.R. 753, 764-65 (1981), in which the Puerto Rico Supreme Court determined that there is an identity of things only "if when deciding on the object of a complaint, the judge may contradict a prior decision affirming a right arisen or arising from, or a right affirmed by a prior court decision." It argues that the superior court's determination of Futura's foreclosure rights is not compromised by our

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separate and distinct corporate entities. . . . Centex itself and S Corporation in turn controlled directly and indirectly defendant Chestnut. . . . [U]pon information and belief, all decisions relative to the operation of co-defendant Homes, S. Corporation and Chestnut and/or "X" Corporation were made by co-defendant Centex and for the sole use and benefit of co-defendant Centex. . . . That upon information and belief *the other corporate co-defendants are in fact alter-egos of co-defendant Centex and that co-defendant Centex and the other corporate co-defendants are one and the same.*

(emphasis added).

finding that the entire sales scheme was a fraud. We do not agree. On a purely practical level it makes no sense for the parties and the court to spend valuable time and resources interpreting a contract if the plaintiff, after an adverse interpretation, can attack the validity of the contract. Secondly, the superior court's decision was premised on the parties' uncontroverted statements that the contract was binding. We, therefore, find an identity of "things".

C. *Identity of Causes*

Futura also seeks protection in §3343's requirement that the "causes" be identical in order for res judicata to apply, and argues that its cause of action in federal court is fraud which is clearly distinct from its previous "contract" causes of action in the commonwealth court.

In *Lausell Marxauch* v. *Diaz de Yanez*, 103 D.P.R. 533 (1975), the Puerto Rico Supreme Court defined "cause" as

> the principal ground, the origin of the actions or exceptions raised and decided, and it must not be mistaken for the means of proof *nor for the legal grounds of the claims adduced by the parties.*

(emphasis added) (translation provided without page reference). Thus, "cause" as used in §3342 does not prevent res judicata from being applied because a new legal theory of recovery is alleged as the following cases illustrate.

In *Gonzales* v. *Mendez*, 15 P.R.R. 682 (1898), the Puerto Rico Supreme Court found that where the mother of a minor daughter had unsuccessfully attempted to rescind a conveyance of her daughter's property on the grounds that she was without judicial authority to make the disposition, she could not later seek the annulment of the contract on the grounds that she did not have the *patria potestas* of the daughter since the object of both actions was to recover an inheritance and annul a deed of conveyance. The court held that "[t]he identity of actions necessary to the existence of res

judicata is present, although the grounds or reasons for the annulment of the conveyance alleged in such actions are different, when the object of such actions is the same. . .[otherwise] the party obtaining a final judgment in his favor would find himself involved in litigation as often as different reasons could be found by fertile imagination, although known when the first action was brought." *Id.* (translation provided without page reference). *See also Manique* v. *Aguayo*, 37 P.R.R. 314 (1927) ("A judgment on the merits in a former suit between the same parties or their privies on the same cause of action, by a court of competent jurisdiction, operates as an estoppel. . .to every. . .matter which might with propriety have been litigated and determined in that action.") In *Zambrana* v. *Superior Court*, 100 P.R.R. 178 (1971), the Puerto Rico Supreme Court again addressed claim splitting and stated:

> The defense of res judicata, in its aspect of splitting of the cause of action, is applicable to every subsequent claim between the same parties relating to the same matter. *Avellanet* v. *Puerto Rico Express*, 64 P.R.R. 660 (1945); *Cruz* v. *Ortiz*, 82 P.R.R. 802 (1961). The purpose of this defense is to further the termination of the judicial controversies and to avoid the continuous hardships caused to one party by successively filing various suits related to the same matter.

Id. at 179.

Futura argues that the fraud cause of action involves different evidence, turns on different facts, and is sufficiently distinct to constitute a different cause and should not be barred under the reasoning of *Gonzalez, Manique and Zambrana.* Here again, we find it difficult to view Futura's fraud claims as a creature apart from the earlier action when its federal complaint states that in addition to the fraud claims this case is an "[a]ction for collection of monies. . .cancellation of certain mortgages. . .assumption of payment of debt; cancellation of

release and liberation of land from p.m. mortgage." In the superior court Futura requested "collection of monies, foreclosure of mortgage, and cancellation of mortgage."

Moreover, Futura alleges that the tort damages flowing from the harm caused by Chestnut's misrepresentation comes to the exact amount owing on the purchase and sales agreement, the very relief sought in the previous action. Fraud damages are designed to put the plaintiff in its pretort position. In this case Futura's damages would presumably be the difference between the 1975 fair market value of the land if sold as a single tract and the value it has already received—the $1.4 million down payment plus the $1.8 million release from its original mortgage liability plus any monies Futura can recover in foreclosure. The relief requested by Futura looks less like fraud damages than an attempt to reform an apparently ill-conceived contract. We think that the facts alleged compel the conclusion that the requirements of §3343 of res judicata have been met in this case.

D. *Res Judicata is Consistent with the Ends of Justice*

Finally, Futura argues that the doctrine of res judicata is not applied under Puerto Rico law if the application would defeat the ends of justice, especially if reasons of public policy are involved. *Millan* v. *Caribe Motors Corp.*, 83 P.R.R. 474 (1961); *Perez* v. *Banza*, 83 P.R.R. 213 (1961).

In *Millan* v. *Caribe Motors*, the Puerto Rico Supreme Court affirmed a superior court judgment allowing a plaintiff to seek rescission of a conditional sales contract although the vendor had previously repossessed plaintiff's purchased truck because of default in payments. The court allowed the second suit to proceed because the plaintiff's consent to repossession in the first suit had been obtained by deceit, there were clear violations of the Puerto Rico Conditional Sales Act in the contract, and the initial repossession action was a summary and special

proceeding. In this case none of the public interest or fraud factors are present. Futura initiated both suits and, by its own admission, was aware of the alleged fraud in September or October of 1981 but made no effort to amend its complaint or alter its litigation strategy.[7] Eight months later, in July 1982, Futura moved for summary judgment relying on uncontroverted facts that asserted the validity of the contract. Therefore, Futura cannot avail itself of the *Millan* fraud exception to res judicata. Nor are the public policy implications in *Millan* present in this case. The contract was not the subject of alleged overreaching or oppressive conduct on the part of Chestnut due to its superior bargaining position and the Puerto Rico Supreme Court has already affirmed the legality of the non-personal liability and foreclosure provisions contained in the mortgage.

The other exceptions to res judicata that Puerto Rico courts have accepted include situations in which: (1) the prior judgment was rendered pursuant to an invalid acceptance of the claim by the defendant; (2) the prior judgment was entered by a court without jurisdiction; or (3) appeal from the judgment was attempted but could not be accomplished and appellant was not at fault. *See Rodriguez* v. *Baldrich*, 508 F. Supp. 614 (D.P.R. 1981) and cases cited therein. Obviously none of these exceptions is applicable to the facts alleged here. Therefore, we find that Futura's commonwealth court claims are barred by res judicata and affirm the decision of the district court.

Affirmed.

Costs awarded to Centex.

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[7] Futura could have amended its complaint to include a new cause of action pursuant to Puerto Rico Rules of Civil Procedure 13.1, 13.4 and 18.